DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15196
San Diego, California

40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission

January 13, 1967 Letter 346

THE MARKET: Even President Johnson is aware of the Lincolnian truth that "you can't fool all the people all the time." Rather than allow the "credibility gap" become a "credibility chasm," he faced a few glaring fiscal facts and asked for a major tax increase of 6% to be levied against corporations and individuals. Think of it, in the face of a tax increase of 6% (estimated to bring in an extra $4.5 billion) the President admits that the nation will nevertheless still face a budget deficit of $8 billion. Many competent observers (this one included) believe the coming deficit, despite a tax increase, could be double the President's figure.

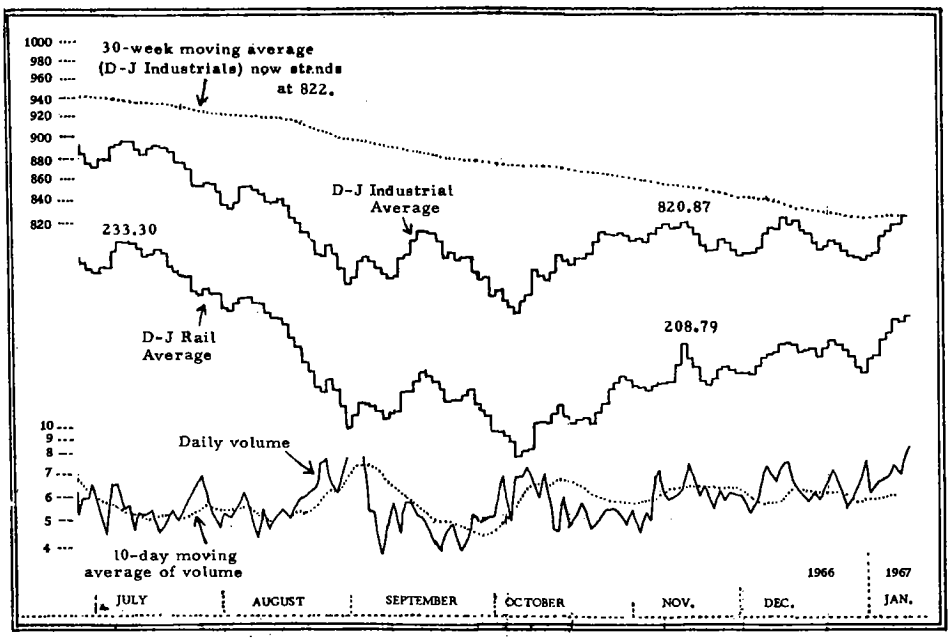
With Social Security rates slated to go up, with labor costs headed for sharper increases than any seen in years, with taxes rising, with individuals and corporations fated to be squeezed by higher costs and higher taxes, it remains to be seen whether today's optimism and earnings will be sustained. Because a primary bear market is in force, this writer predicts that 1967 will see a drop in consumer sentiment, consumer volume of sales, corporate profits and national income.

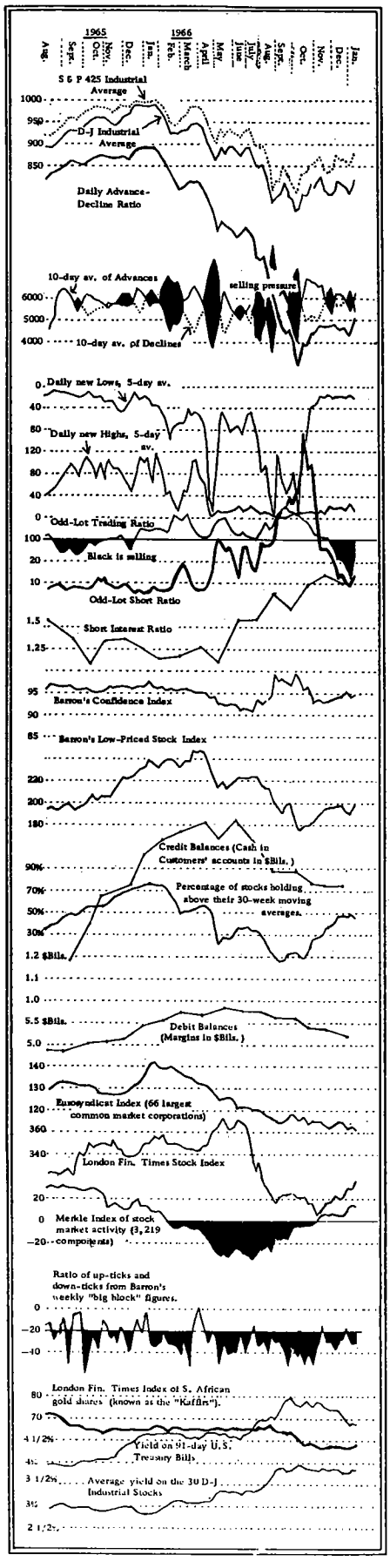
* * * *

In the face of the current confusion, even such staid institutions as the Cleveland Trust have thrown away their "projection charts." State the economists in the latest Cleveland Trust Bulletin, "Projections are out for 1967. Only predictions can be made because there is no sound empirical basis for 'projecting' the final mix of monetary policy, fiscal policy and defense spending that will develop."

From the standpoint of the Dow Theory, there is little need to drive oneself to distraction in an attempt to figure out "what comes next on Wall Street." A primary bear market started last February. According to Dow Theory tenets, the tide is slowly running out for the bulls, and regardless of violent rallies, double or triple tops, rekindled hopes or Presidential wishes, the primary bear forces will ultimately express themselves.

In Letter 344 I discussed the tidal principle, illustrating this with the example of a man placing a stick at the point where each wave of the ocean spends itself. At a certain point the waves fail to wash past the stick and that point represents the peak of high tide. From then on the waves begin to recede. By the same token, it seems to me




1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Block is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eusoyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

that the waves of the stock market have been receding during this bear market.

The bull market peak was reached last February at 995.15. Then during March and April the Industrial Average rallied repeatedly, but this time the waves halted at 954.74. A new decline ensued, and during May and June three successive upward waves failed to better the 903.22 level. A third collapse took the Dow to lows in October, and since then two sharp upward sweeps have attempted to surpass the 820 level (820.87 in November, 820.54 in December). Currently, a third wave is heading towards the 820 area. Perhaps the Dow will succeed in surpassing the November peak of 820.87 on this thrust, but even if this does occur I would not turn bullish on the future of this market. I would expect any rise from here to be frantic and short-lived. During primary bear market years, all too often the yearly high is struck in January (this probably occurs due to insistent demand for reinvestment during the early part of the new year), followed by a resumption of the major (bear) trend.

NOTES & QUOTES: I have been reading a fascinating book entitled "The Merchant Bankers" by Joseph Wechsberg (Little, Brown Co. Boston). I was particularly struck by the author's description of England at its height of power: "After the Napoleonic Wars, England emerged as the financially safest country, the only country on earth that never borrowed. The Continent's capitalists in Amsterdam and Frankfurt, London, Paris and St. Petersburg sent their funds to London, the great clearing house. Consuls became the gilt-edged securities and sterling the world's currency. Britain's financial prestige was closely allied to her maritime power. After Waterloo all governments in need of money—France, Prussia, Austria, Russia, Portugal, Spain—came to the City (London). The great merchant bankers listened to their propositions and either arranged loans—or didn't. Often they didn't, which made them only more powerful.

"During the nineteenth century the City's merchant bankers channeled the capital surplus at home into profitable investments abroad. Gold and currencies were freely transferable, and currency values remained stable. There were no taxes, no restrictions for the bold entrepreneur, almost no public controls. The banker's main problem was to invest fast and well..." (My note: how times have changed).

* * * *

With all the talk about the short interest, Chartcraft (Larchmont, N.Y.) has come up with the following interesting fact. The short interest in the 30 Dow stocks has been falling. From a high of 1.2 million in October, 1966, the short interest in the Dow stocks has fallen to a low of 914 thousand in December, a drop of 29%. Thus, it seems apparent that a large percentage of the shorting has gone into the speculative segment of the market, rather than the giant blue-chip companies. This would mitigate much of the talk about the big short position being a prop under the market. Certainly the short position is not a prop under the Industrial Average.

* * * *

From The Janeway Letter (311 E. 50th St., N.Y.C.): "Steep and stiff new excise taxes loom as a clear and present danger on the 1967 horizon. Take this as our first warning that 1966's unresolved quandary about income tax rates may well be traded into a compromise settlement for excise taxes.

"The mere possibility is admittedly a shocker. But the Administration's procrastination about income taxes has opened the door for this compromise; and its loss of rapport with Congress is forcing it to consider going this route. If (as we are positive he will) Johnson understates the prospective deficit; and if (as we know is the case) the Government needs revenue; his tactic plus his need will add up to the inescapability of a compromise on higher excise taxes.....Meanwhile, there's no doubt that the stock market is on to the scent, for the big retailing stocks made new lows in December." (January 3).

And from the January 4 Janeway Service: "The prospect (for 1967) is for a tangle in the form of a stall on his (Johnson's) request for higher income taxes; and also for a massive breakthrough in Government spending programs unrelated to war—this on top of the Pentagon-powered spending inflation which is now recognized and admitted on every side. On both the revenue side and the spending side, therefore, all indications point to a budget deficit of crisis proportions."

* * * *

From the January 6 Dines Letter: "Silver futures rocketed to new highs this week for a major upside breakout, underscoring the increasingly bullish tone of the silver group.....Johnson only has two options open to him that we can see: namely, repudiate the silver certificates (which would buy another 6 or 7 months time) or half sales of silver from the Treasury. This latter course would finally permit silver to rise to its appropriate price level based on supply and demand, and the long-awaited explosion in earnings of silver miners would arrive."

Going over the records of the past, a great many years (in which a primary bear market was actually in progress) saw their highs for the year in January. These years were 1903, 1906, 1907, 1910, 1913, 1914, 1917, 1920, 1931 (high for year in February, 1931), 1939, 1940, 1941. Therefore, since a primary bear market started in February, 1966, and since that bear market is still in effect, it would not surprise me at all to see the highs for 1967 struck this month—or possibly in early February.

It should be remembered that time is the enemy of the stockholder during primary bear markets. This is true because values are deteriorating while the bear forces are holding sway. Thus, even though a bear market is subject to numerous (and often violent) secondary upward reactions, these reactions are technical in nature, and the fundamental situation continues to weaken during the life of the bear market. Consequently, each (technical) rally in a bear market ends with the fundamental conditions in worse shape than they were before the rally began. The market recognizes this by breaking to successive new lows following each rally.

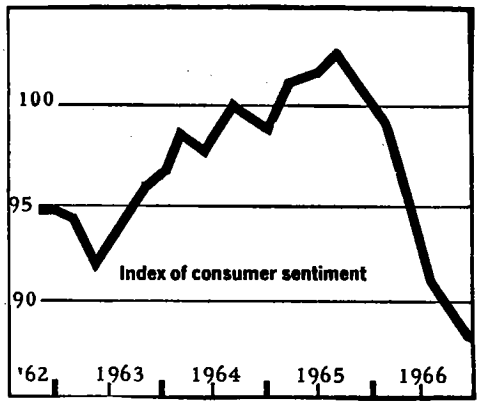
* * * *

Like Pavlov's famous dogs, today's generation of stockholders have been conditioned by the following sequence. The bull market is interrupted by a major secondary reaction (as per 1953, 1957, 1960, 1962) which hits bottom in a matter of months. Then as the market turns up and embarks on a long advance to ultimate new highs, the economy goes into recession. But the rising stock market is already discounting the end of the economic recession and the subsequent new boom, and investors who wait for the actual news of the end of the recession are fated to be left far behind. Why should the 1966 collapse be any different than the other cave-ins since World War II? This is the crux of the current investment problem.

For if a primary bear market started in February, 1966 then the nation faces something entirely different from 1953, 1957, 1960 or 1962. It faces a long, drawn out, deceptive decline in prices, a decline which will terminate far lower and under far more discouraging conditions than those envisioned by the majority of today's investors. But there is a "silver lining," and it is that today's primary bear market will also produce great values and fortune-making opportunities for those who have the patience and will to conserve their funds until somewhere near the final bear market bottom.

Remember the reactions during the 1949-66 bull market? Each of them looked very much like a true bear market while they were in progress. By the same token, the current (upward) reaction in the bear market is obviously "the big one," the one that is destined to look like the beginning of a true bull market. I warn subscribers against accepting today's deceptive rise as the beginning of another primary bull market. My bet is that today's market will look far different (and be far lower) by the time 1967 is out.

* * * *



In the January 9 issue of the Wall Street Journal, George Shea (page 1) notes that while "the debate continues over whether the country is going to suffer a general business recession, the single fact is that much of the private portion of the economic system is already in recession." This has been offset, to some extent, by higher Government (Vietnam) spending. Shea goes on to note that autos, housing and steel are now in a slump as are appliances.

Particularly interesting to me is the latest report from the Survey Research Center of the University of Michigan. The accompanying chart shows that "Consumer Sentiment" has dropped to the lowest level in many years. This chart is based on consumers' attitudes about the economy and consumers' "intentions to buy." According to the Michigan study, "A further deterioration of consumer sentiment appears to be dependent on new bad news." What could such bad news be? States the Michigan study, the bad news could be a tax increase and higher interest rates. On January 10 President Johnson delivered half of the potential "bad news package," and it remains to be seen how the American consumer reacts to a further personal stake in financing the nation's Great Society and military adventures.

SLOGANS: One of the most overworked slogans on Wall Street is that "this is a market of stocks." The sister slogan to this is, "You can't buy the Averages." In my mind, both of these tired epithets have, over the years, cost investors a good deal of money. They tend to cost investors money both in bull markets and bear markets, and here is why.

Everyone knows that the market is made up of individual stocks, and that individual stocks can move in any direction they wish. But what most people do not fully comprehend is that Wall Street is both a game of knowledge and nerve—and a game of odds. No matter how intelligently you choose a company, if the odds are against you, then you are very apt to lose money in your choice of a stock. For instance, no one doubts that Dow Chemical is an excellent, well-run growth company, a company which should do well over any extended period of time. Yet over the past year Dow has lost over one quarter of its market value. What happened? Holders of Dow were caught in a broad bear trend, a trend which knocked down price-earning ratios in the great majority of stocks.

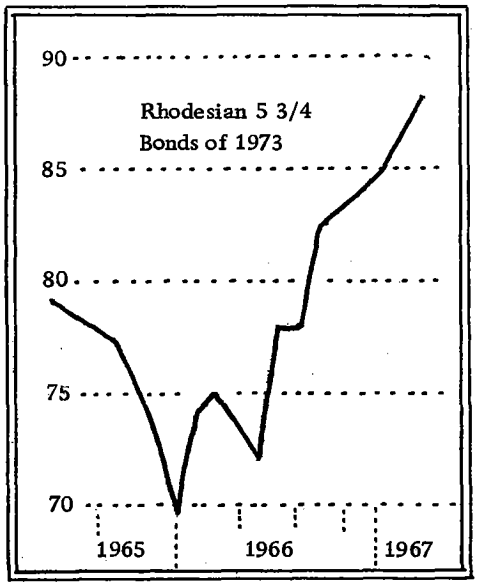
In other words, during 1966 the odds were against the stockholder in the market. Very few stocks were able to hold out against the primary bear trend. Those who bought or held stocks during 1966 did not understand the concept of market odds; they did not understand that careful research and careful selection were not enough. The proof is available for all to see. During the bear year 1966 only 252 stocks advanced (i.e. ended the year higher) while 1185 stocks ended the year lower. Thus the odds during 1966 were almost 5 to 1 that you would pick a "loser" on the New York Stock Exchange. Ask any Las Vegas gambler whether he would put money down at 5 to 1 odds against him. You couldn't get a taker in the state of Nevada.

What occurs in a primary bull year? In 1964 the story was different. That year 1022 stocks advanced and only 395 stocks declined. Odds of better than 2 to 1 that your stock was going up. And if you selected carefully, there was no question that everything was working for you. In 1965, a much more mixed year (high-grade stocks topped out in mid-1965) the odds were still with the stockholder. The year 1965 ended with 905 stocks higher, 519 stocks lower. A little less than 2 to 1 in favor of the stockholder. So do not forget this—you need the odds in your favor in the market. It may be a market of stocks, but it is also a market of odds. Anyone with any brains and experience on Wall Street wants to be on the right side of the odds. This means being invested in a bull market and being out during a bear market.

I want to say a bit about the second slogan, "you can't buy the Averages." As Mr. Hamilton Bolton has stated in the past, you can just about buy the Averages today. You can buy them by purchasing shares in a selected mutual fund or a closed-end fund. Any large fund contains a broad list of representative shares. If you do not wish to go through the bother and agony of selecting individual stocks at the beginning of the next bull market, than you can simply purchase shares in a fund. For instance, Tri-Continental, the world's largest closed-end fund (listed on the N.Y.S.E.), could have been bought all year in 1949 for 3½. It hit a bull market high of 27 in 1965. That isn't a bad rise for the bull market, considering that dividends would have been collected for 17 years. In 1942 Tri-Continental could have been purchased for under $1. Conclusion: You may not be able to buy the Averages, but you can do almost as well—you can buy a fund which holds a representative list of stocks.

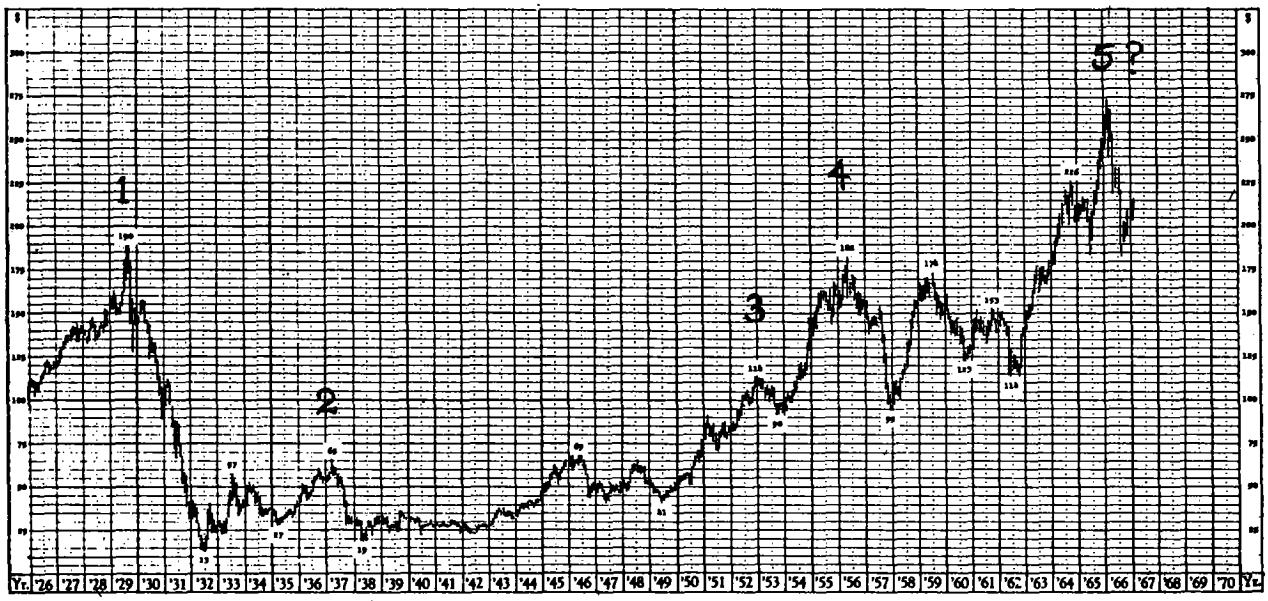
So there are two of Wall Street's favorite slogans. Both of them are deceptive as far as I am concerned. But it is extremely valuable to understand why these slogans are half-truths, more harmful than helpful for purposes of making long-term profits in the market.

SOUTH AFRICAN GOLDS: Most of my subscribers hold hedge positions in both Canadian and S. African golds. Among the recommended Africans are Free State Geduld, Western Deep Levels, Western Areas, President Brand, and the closed-end trust, American S. African. One of the great worries of holders of S. African gold shares (yields are now whopping, running up to 15%) is the political situation in Rhodesia.



Talk is cheap on the political fronts, rumors are usually worthless. What I am interested in is the opinion of the "hard money," the men who put their cash where their mouth is. For this reason I have been following the bonds of the Rhodesian government. The chart on this page is rather startling. For despite all the talk, the Rhodesian 5 3/4% bonds of 1973, after dropping to a 1965 low of 69½, have now recovered to the highest level since the Rhodesian crisis. Last week these bonds were quoted on 88¼, and the chart suggests that these bonds (which represent the debt of the Rhodesian government) have embarked on a major rise in the face of all the talk about trouble in Rhodesia. In my opinion, the coldest cash in the world (i.e. international bond money) is saying that the worst is over for Rhodesia. This should represent a large plus for S. African gold shares.

DOW-JONES RAIL AVERAGE



RAIL CHART: I am including the long-term (monthly) chart of the D-J Rail Average from Horsey & Co.'s "25-Year Picture" (37 Wall St., N.Y.C.). This chart is particularly interesting to me at this time. Note that over the past forty years there have been four "head-and-shoulder" patterns in the Rail Average. These occurred in 1929-30, 1936-37, 1952-53, and 1955-57. The head-and-shoulder top is almost always a distributive pattern, and each time this formation has occurred in the Rails the danger signals were flying. With the exception of 1953-54, all the head-and-shoulder tops in the Rail Average were followed by sizable and costly drops.

The previous two largest H & S tops in the Rails occurred during 1929-30 and 1955-57. Each of these were followed by major drops, although of course, the drop which followed 1930 dwarfed the 1957 slide. Nevertheless, note that the drop of 1956-57 cut the Rail Average almost in half (181.23 in 1956 to 95.98 in 1957).

Currently, the D-J Rail Average is in a formation which in size compares only with the formations of 1929-30 and 1956-57. The "left shoulder" of the Rail H&S peaked in 1965 at 224.91 (closing basis). The "head" topped in 1966 at an all-time Rail high of 271.72. A "right shoulder" seems now to be developing in this massive potential Rail top. If the formation is to be roughly symmetrical (as they often are), we might expect the current right shoulder in the Rails to reach the 217 to 225 area, which would correspond to the 1964 high. While no two markets are ever alike (would that it were that easy), I felt that the foregoing analysis was interesting enough to bring to the attention of my subscribers. "Let the buyer beware."

QUOTE OF THE WEEK: (From a U.S. News & World Report interview with Maurice Stans, former Director of the Budget): In answer to whether he thought a recession in business was coming, Stans answered, "It's a bit presumptuous to make such a prediction, but I would say the signs now point to a leveling off and a potential decline in the civilian side of the economy." Later question: "Do you think the deficit could be much greater than the figures now being projected?" Answer: "If we should have any kind of recession at a time when our expenditures are as high as they are now, and when we are already operating at a significant deficit, the Government could end up the year with an over-all deficit of 30 or 40 billion dollars."